



**TC03289**

**Appeal number: TC/2011/05945**

*Corporation tax – deemed charge under s419 ICTA 1988 on loan to participator – investment in close company – shareholder agreement – subscription for shares payable by instalments – instalments not paid – whether loan to participator – no – Appeal allowed*

**FIRST-TIER TRIBUNAL  
TAX CHAMBER**

**RKW LIMITED**

**Appellant**

**- and -**

**THE COMMISSIONERS FOR HER MAJESTY'S      Respondents  
REVENUE & CUSTOMS**

**TRIBUNAL: JUDGE MICHAEL S CONNELL  
Dr CAROLINE J SMALL**

**Sitting in public at 45 Bedford Square London WC1 on 15 – 16 November 2012**

**Ms Felicity Cullen QC for the Appellant**

**Mr Luke Connell, Officer of HM Revenue and Customs, for the Respondents**

## DECISION

- 5 1. This is an appeal by RKW Ltd ('the Appellant') against a discovery assessment of £542,525.50 in respect of its accounting period ending 31 December 2000 on the basis that a liability arose under s419 ICTA 1988 (loans to participators) in respect of unpaid share capital of £2,170,102, where the subscription price for shares in a close company was payable by instalments.
- 10 2. The Tribunal is required to decide only whether in principle any liability to tax under s419 ICTA 1988 has been incurred by the Appellant. The amount in issue is not before the Tribunal.
- 15 3. The documentation before the Tribunal comprised a joint list of agreed documents, relevant legislation and authorities, together with an agreed statement of facts. There was no witness evidence. The agreed facts are stated in paragraphs 4 to 27 below.

### The Facts

4. On 28 August 1998 the Appellant was incorporated (as Toneformat Limited) with an issued share capital of two ordinary shares.
- 20 5. The Appellant Company's registration number is 3623235 and, until about October 1998, its shareholders were Instant Companies Ltd and Swift Incorporations Limited. From about October 1998, the directors of the Appellant were Mr P J and Mrs P A Whitehouse, Mrs A I Richardson, Mrs BT Keen and Mrs H Thomas. Mr D L Hay was company secretary.
- 25 6. On 8 October 1998, the Appellant's name was changed to RKW Limited. The first financial statements prepared covered the period 28 August 1998 to 27 February 2000, and indicate that the Appellant commenced trading on 16 February 1999.
7. The Appellant's principle activities were the provision of authentic table dancing and cafes.
- 30 8. By November 1999 a number of individual shareholders, most of who are members of the Richardson family, had subscribed for ordinary one pound shares in the Appellant.
9. One of the shareholders, Mr G Richardson, died on 27 May 2006.
- 35 10. The identities of the shareholders and the size of their respective shareholdings in the Appellant in the early part of 2000 (as set out in the Appellant's annual return form 363a filed on 14 November 2000) were as follows:

Mr G Richardson	£1 ordinary shares	1,616,225
Mrs A Richardson	£1 ordinary shares	1,616,225
Mr P Whitehouse	£1 ordinary shares	252,048
Mrs H Thomas	£1 ordinary shares	9,000
Mr B Keane	£1 ordinary shares	331,652
Mr A Richardson	£1 ordinary shares	528,097
Mrs P Whitehouse	£1 ordinary shares	252,049
Trustees for minor children of the above shareholders	£1 ordinary shares	15,000 (3 x 5000)

11. All of the above shareholders ('the Richardson Shareholders') were understood to be directors of the Appellant

12. During 2000 the directors of the Appellant identified a potential new investor who had extensive knowledge and experience of the Appellant's field of business. This investor was Mr John Gray ('JG'). It is agreed for the purposes of this case that JG is a US citizen who is (and was at all material times) resident in California. It is further agreed for the purposes of this case that none of the Richardson shareholders was at any time prior to conclusion of the agreement referred to in paragraph 16 below connected with JG.

13. Following discussions between the contracting parties, terms on which JG would subscribe for shares in the Appellant were agreed in principle. These terms were recorded in an agreement dated 20 November 2000 between JG, the Appellant and the existing shareholders in the Appellant ('the Shareholders Agreement').

14. All dealings relating to the negotiation and conclusion of the Shareholders Agreement took place on arm's length terms.

15. The copy of the Shareholders Agreement, which is available before the Tribunal has not been signed by the Appellant and JG. It is however agreed that a copy of the Shareholders Agreement was signed by those parties on or about 20 November 2000 and that the Shareholders Agreement did take effect and became binding on all of the parties to it following signature by the last to sign.

16. Under the terms of the Shareholders Agreement, the existing shares in the Appellant held by the Richardson shareholders were to be designated as "A ordinary shares" and JG was to subscribe for 4,808,880 "B ordinary shares".

17. The B ordinary shares would carry equal voting rights to the A ordinary shares and, given the relative numbers of A ordinary shares and B ordinary shares, would give JG voting control of the Appellant (clauses 21 – 23 of the Shareholders Agreement).

5 18. Clause 20 of the Shareholders Agreement provided that the B ordinary shares were issued for a subscription price (calculated by reference to par value) in cash as follows:

10 “20) JG shall subscribe for the B ordinary shares for cash at par and shall pay for that subscription in the manner and on the dates set out in schedule 4. The B ordinary shares shall be fully unconditionally and irrevocably issued in consideration of the agreement of payments herein and as detailed herein within schedule 4. Said agreement of payments is considered by the parties hereto, and each of them, that the same represents valuable consideration to each of them. The share to JG shall irrevocably be issued to JG immediately upon the signing hereof by the parties hereto. [Withstanding anything to the contrary contained herein, inclusive of all attachments hereto, the parties hereto, and each of them, agree that JG is hereby acquiring a full 51% majority ownership in the company.]

20 The parties hereto, and each of them, further agree that they desire JG to become involved as JG retains extensive table dancing related experience and resources considered to each of the parties hereto to be an incalculable benefit to each of them and RKW in the circumstances."

25 19. The subscription price of £2,170,102 for the B ordinary shares was payable in four instalments as set out in schedule 4 to the Shareholders Agreement (clause 20 of the Shareholders Agreement) as follows:

"Commencing one year after the signing of this agreement, or soon as may be elected by JG, and continuing on each annual anniversary three years thereafter, or soon as may be elected by JG, JG shall pay the following amounts ("the subscription payments") to the company as follows:

30 upon one year from the signing hereof the sum of £500,000

the second payment as hereinabove detailed the sum of £500,000

the third payment as hereinabove detailed the sum of £500,000

the fourth payment as hereinabove detailed the sum of £670,102

35 Interest shall be charged (4% above AIB base rate) on all unpaid subscription payments and shall be due and payable in addition to all unpaid subscription payments."

40 20. The sums referred to in schedule 4 of the Shareholders Agreement were included in the Appellant's balance sheet (in all relevant years) under the heading "debtors". Note 11 to the financial statements for the period ended 31 December 2000 provides as follows:

5                   “On 20 November 2000 the existing 10,000,000 authorised ordinary shares were redesignated as "A" shares. The authorised share capital was increased by the creation of 4,808,880 ordinary "B" shares of 45.12697p. The shares were immediately issued for cash at par to extend the capital base of the company. The consideration is payable by instalments over a period of four years. The “A” and “B” shares rank pari passu in all respects.”

21. Note 12 to the financial statements for the period ended 31 December 2000 states (by way of illustration) that it was the net present value of the consideration for the B shares which was included in Debtors as follows:

10                   "other reserves represent non-distributable reserves arising as a result of the issue of shares in the period for cash consideration of £2,170,102 as detailed in note 10. The consideration is due to be paid over a four year period. The net present value of this consideration is £1,862,258 and the resulting difference has been debited to other reserves”.

15   22. JG did not make the payments provided for by schedule 4 to the Shareholders Agreement.

23. The Appellant was at all material times a close company as defined in s414 Income and Corporation Taxes Act 1988 ("ICTA 1988").

20   24. HMRC consider that JG was a participator in the Appellant who incurred a debt of £2,170,102 (for the purposes of s419 ICTA 1988) to the Appellant on entering into the Shareholders Agreement. On 20 November 2006 HMRC assessed the Appellant to tax under s419 ICTA 1988 on that basis.

25   25. In the alternative HMRC consider that a liability to tax under s419 ICTA 1988 in respect of the debt of £500,000 arose one year following the entering into of the Shareholders Agreement when the liability to pay the first instalment payment in accordance with schedule 4 to the Shareholders Agreement was not satisfied. On 20 December 2007 HMRC assessed the Appellant to tax under s419 ICTA 1988 on that alternative basis.

30   26. The Appellant considers that s419 ICTA 1988 cannot apply where the transaction purportedly characterised as a debt (for the purposes of s419 ICTA 1988) concerns the making of an investment by an incoming participator (as distinct from a transaction which involves an extraction of assets or profits from the company); and considers further that an incoming participator (with no prior interest in a company) is not a participator for the purposes of s419 ICTA 1988 at the time at which he  
35   subscribes for shares, but only becomes a participator as a consequence of that transaction.

27. The present appeal is against the assessments referred to above

40   28. In 2005 a number of transactions were entered into which gave rise to relief from any liability (which contrary to the Appellant's position may have arisen) under s419 ICTA 1988. The collectible liability to tax (if any) is accordingly limited to

interest on tax as agreed and set out in an amended Notice of Appeal dated 4 August 2011.

29. Following the agreed statement of facts the Appellant amended its grounds of appeal (because they more accurately reflect the points in issue) as follows:

- 5 (a) no "debt" (within the meaning of that expression in the context of section 419(2)(a) ICTA 1988) is incurred on the occasion of, or in respect of, a subscription for shares in a close company including such a subscription where, under the terms on which he acquires shares, the subscriber incurs a liability to pay for the shares in instalments (on future dates);
- 10 (b) if (contrary to the Appellant's position as set out in (a) above) a debt can be incurred in respect of the subscription for shares in a close company where the shareholder incurs a liability to pay for the shares in instalments on future dates no debt will be incurred until the date on which the respective future instalments are to be paid;
- 15 (c) even if (contrary to the Appellant's position as set out in (a) above) a debt can be incurred for the purposes of section 419(2)(a) ICTA 1988 on the occasion of, or in respect of, a subscription for shares in a close company, no liability to tax under section 419(1) ICTA 1988 arises where the subscriber is not a "participator" until the time at which the debt arises;
- 20 (d) In circumstances where a liability to tax under section 419(1) ICTA 1988 is discharged (under section 419(4) ICTA 1988) before being paid, HMRC is entitled to collect only the interest due on the discharged liability to tax under section 419(1) ICTA: - ss 419(4) ICTA, ss109, 87A and s91 Taxes Management Act 1970 (TMA 1970): to the extent that the Appellant is
- 25 unsuccessful in its appeal it is agreed between the parties that HMRC is on the facts and on this basis entitled to collect only interest due on any discharge liability to such tax as is found to have been due under section 419(1) ICTA 1988.

#### Relevant Legislation

30 30. Section 419(1) and (2) ICTA 1988 provide (so far as relevant) as follows: -

35 “(1) Subject to the following provisions of this section and section 420, where a close company, otherwise than in the ordinary course of a business carried on by it which includes the lending of money, makes a loan or advances any money to an individual who is a participator in the company or an associate of a participator, there shall be due from the company for the accounting period in which the loan or advance is made, an amount equal to 25 per cent of the loan or advance.

(2) For the purposes of this section the cases in which a close company is to be regarded as making a loan to any person include a case where –

- 40 (a) that person incurs a debt to the close company; or
- (b) a debt due from that person to a third party is assigned to the close company;

and then the close company shall be regarded as making a loan of an amount equal to the debt.”

31. "Participator" is defined in s417(1) ICTA 1988 as follows:

5 " (1) For the purposes of this Part a "participator" is, in relation to any company, a person having a share or interest in the capital or income of the company and, without prejudice to the generality of the preceding words, includes –

- 10 a) a person who possesses, or is entitled to acquire, share capital or voting rights in the company;
- b) any loan creditor of the company;
- c) any person who possesses, or is entitled to acquire a right to receive or participate in distributions of the company (construing "distributions" without regard to section 418) or any amounts payable by the company (in cash or in kind) to loan creditors by way of premium on redemption; and
- 15 d) any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for his benefit.

20 In this subsection references to being entitled to do anything apply where a person is presently entitled to do it at a future date, or will at a future date be entitled to do it."

The Appellant's case

32. In outline, the Appellant's case is that s419 ICTA 1988 can, on the facts of this case, apply only if: -

- 25 a) the extended meaning of loan provided by s419(2)(a) ICTA 1988 applies, i.e., if John Gray incurred a debt to the Appellant by subscribing for the B Ordinary Shares in the Appellant on the terms that he did; and
- b) John Gray was a participator in the Appellant at the time at which any such debt was incurred by him.

30

33. The Appellant's position on the issues set out in paragraph 32(a) and (b) above is as follows:

Argument A

- 35 a) The terms "debt" (as used in s419(2)(a) ICTA 1988) is one which takes its meaning from its context; and, in the context of s419 ICTA 1988, the term "debt" does not extend to a liability to pay the price for shares by instalments on future dates.

40 If the Appellant succeeds before the Tribunal in its Argument A, no liability to tax will arise: the decision will simply be that, in the context of s419 ICTA 1988, "debt" does not extend to the liability to pay the subscription price for shares, so that no liability under s419 ICTA 1988 arises.

## Argument B

5 b) Alternatively, the meaning of the term “debt” should, in the context of a subscription for shares and of s419 ICTA 1988, be informed by the company law analysis of the position; as a matter of company law, when shares are issued for a subscription price which is payable in instalments, no debt arises until an instalment becomes due, (and then only to the extent of the instalment which has become so due).

10 If the Appellant does not succeed before the Tribunal in its Argument A, but succeeds in its Argument B, a liability to tax will arise under s419 ICTA 1988 in respect of the single instalment of £500,000 which became payable in respect of the B Ordinary shares in the Appellant one year after the signing of the Shareholders Agreement i.e. on 20 November 2001. (On the assumption that John Gray incurred a debt on any date after the date on which the Shareholders Agreement was executed, it is accepted that he cannot rely, to that extent, on Argument C.)

## Argument C

20 c) Even if, which the Appellant asserts is not the case, an agreement to subscribe for shares for a subscription price payable in instalments gives rise to a debt at the date of the agreement to subscribe, on the facts of this case, John Gray was not a “participator” in the Appellant at the time at which such a debt (“the Assumed Debt”) was incurred; he became a participator as a result of entering into the Shareholders Agreement under which he incurred the Assumed Debt. In other words, John Gray did not incur the debt in the capacity of participator; and only acquired that capacity in consequence of subscribing for the shares and incurring the Assumed Debt.

30 If the Appellant does not succeed before the Tribunal in its Argument A, but succeeds in its Argument C, no liability to tax under s419 ICTA 1988 will arise under the Assessment on the following basis. Even if the Assumed Debt was incurred by John Gray on entering into the Shareholders Agreement, he was not a participator at the relevant time and s419(1) ICTA 1988 was not engaged.

## Argument A

### ***The meaning of “debt” in s419 ICTA 1988***

40 34. The Appellant argues that the meaning of the word “debt” depends very much on its context. In the case of *Marren v Ingles* (1980) 54 TC 7, the taxpayer sold shares in a private limited company. Part of the sale proceeds were paid immediately, plus a further amount becoming payable if the company subsequently became quoted on the Stock Exchange and the first day trading price exceeded a certain amount. As both of



these conditions were met, the taxpayer received further deferred consideration. HMRC issued capital gains tax assessments, contending that the taxpayer's right to receive the deferred consideration was an asset and that the further consideration derived therefrom constituted a disposal of the asset for CGT purposes. The taxpayer  
5 appealed, contending that the deferred consideration was a debt which was exempt under paragraph 11 of Schedule 7 to the Finance Act 1965, which provided that:

'where a person incurs a debt to another.. no chargeable gain junction to that (original) creditor ... Or disposal of the debt..'

The taxpayer also argued that the payer of the deferred consideration did not acquire  
10 an asset with the consequence that there was no disposal for capital gains tax purposes.

It was held that there had been a disposal for capital gains tax purposes, since the taxpayer's right to receive the deferred consideration was a "chose in action" (i.e. an asset) and the payment of the further consideration was a capital sum derived from  
15 this asset. The payment of the deferred consideration was not a debt within para 11 of Schedule 7 FA 1965. It was held that where there is a disposal of a chargeable asset and there is the possibility of further consideration being received, conditional on future events, the right to receive the future consideration must be valued and brought into account as part of the sale proceeds on the original disposal.

20 Templeman LJ said at 54 TC 94A

'in the present case the object of excluding as a chargeable gain a debt in the hands of the original creditor can only be to ensure that the ordinary simple debt on which a holder cannot make a gain but may make a loss, shall not be brought within the ambit of capital gains tax legislation, the object of which is to set off chargeable  
25 losses against chargeable gains to produce liability to tax. Moreover, whatever the context in which 'debt' is to be construed. I cannot believe that it applies to the present case, to what was a possible liability to pay an unidentifiable sum at an ascertainable date' ...

Lord Fraser said at 100 (and with whom Lord Russell of Killowen agreed)

30 "Mr Price cited to the learned Judge and reiterated to this Court that the meaning of the word "debt" depends on its context. With that I am in full agreement."

35 35. In the recent case of *Aspect Capital Limited v HMRC* [2012] UKFTT 430 which turned on the meaning of "debt" (para 155), the Tribunal does not appear to have been addressed on *Marren v Ingles* and stated (at para 221) that it was "merely applying the normal meaning to "debt"". However in that case there was no need for the Tribunal to consider doing otherwise. As Judge Barbara Mosedale said (at para 191):

40 'there are situations when no debt has yet arisen but may arise on the occurrence of an uncertain event and (such as litigation which might lead to a judgement debt or a partly paid share where there might be a call to pay the balance). But these situations are in contrast to case, such as the one in this appeal, when the supplier under contract has completed his obligations. In such cases a debt arises

immediately even though it may only be due for payment on a deferred date and even though it might be waived on the occurrence of a future uncertain event. In such a case a debt arises from the moment the contract for goods or services is completed.'

- 5 36. It is the Appellant's position that, in accordance with the House of Lords decision in *Marren v Ingles*, the correct approach is to consider the meaning of the term "debt" in context; and this means considering the meaning of "debt" in the context of s419 ICTA 1988, the mischief at which it was aimed and the facts.

***The mischief at which s419 ICTA 1988 is aimed***

- 10 37. The mischief at which s419 ICTA 1988 is aimed or directed ("the 419 Mischief") can be extracted from the decision of the Court of Appeal in *Brennan v Deanby Investments* [2001] 73 TC 455 at p.466: -

15 "The legislation includes provisions to counter avoidance of tax by the making of loans or advances of money to participators of close companies. Were it not for these provisions, participators could enjoy the use of the income of a close company free of tax if the company were to make loans to them instead of paying dividends or remuneration; the loans could then be allowed to remain outstanding indefinitely or could be waived or written off."

- 20 38. Subsection (2) of s419 ICTA 1988 – which must be engaged if a charge to tax is to arise – was introduced by the Finance Act 1969 during the course of events in *Stephens v Pittas* [1983] STC 576. (Schedule 14 para 2 FA 1969 amended s75 FA 1965, the predecessor provision to s419 ICTA 1988 (and s286 ICTA 1970) and the relevant provision is in s419 (2) ICTA 1988).

- 25 39. The case of *Stephens v Pittas* concerned sums which were misappropriated from a company by a controlling shareholder. It was held that the (non-consensual) misappropriations did not constitute a "loan or advance" by the company, but for the years in which the extended definition of loan (in s419 (2) ICTA 1988) was in force, did constitute the incurring of a "debt".

- 30 40. The 1969 amendment was designed to extend the meaning of a loan so that s419 ICTA 1988 would be engaged on facts such as those in *Stephen v Pittas* and facts such as those in *Grant v Watton* [1999] STC 330 (where services were provided on credit).

- 35 41. The s419 mischief can be broadly described as being directed at the untaxed extraction of profits, assets or value (in the sense of services) from a close company by its shareholders (participators).

- 40 42. The making of an investment in a company, being the transaction which took place in this case, is far removed from the s419 mischief. The investment involves the obligation to contribute to and enhance the assets of a company and the performance of that obligation, rather than the extraction of money or value from it.

43. A person investing in a company (even one making an investment in instalments) is not, in that capacity, whether in the ordinary sense of the word, the contextual sense of the word, or in any sense of the word, a debtor of the company (and does not, in making the investment, incur a debt to the company).

5 44. In the case of a subscription for debentures, the obligation to invest does not give rise to a debt: *South African Territories Ltd v Wallington* [1898] AC 309 HL. The headnote to the case, which concerned an action for specific performance, provides as follows:

10 “The rule that specific performance cannot be granted in respect of a contract to lend money applies to a contract to lend to a company money, payable by instalments, upon the security of debentures to be issued by the company.

15 Where the lender makes default in payment, the moneys due for unpaid instalments do not constitute a debt to the company, and the company is only entitled to damages for the actual loss by the breach of contract.”

45. Lord Herschell stated as follows at p.308: -

20 “But for the fact that Wright J arrived at another conclusion, I should have thought it equally clear that the sums of money constituting the instalments which the defendant agreed to pay did not constitute a debt. It was argued that the defendant had agreed to purchase certain debentures of the company, and that the moneys sought to be recovered were the price of the debentures so agreed to be purchased. I think this is a fallacy. The transaction was not in its nature a contract of purchase: it was an agreement on the one side to lend money for a term of years, and on the other side to give the lender the specified security for his loan. I am at a loss to see how an agreement of this description can create a debt from the lender to the borrower.”

30 46. Lord Herschell made clear that the person subscribing for the debentures, thereby lending to the company and becoming the creditor of the company, could not be described as incurring a debt to the company nor, by implication, as the borrower or the debtor.

At 315 per Lord Herschell said:

35 “It was argued that the defendant had agreed to purchase certain debentures of the company, and that the moneys sought to be recovered were the price of the debentures so agreed to be purchased. I think this as a fallacy. The transaction was not in the nature of a contract of purchase: it was an agreement on the one side to lend money for a term of years, and on the other side to give the lender the specified security for his loan. I am at a loss to see how an agreement of this description can create a debt from the lender to the borrower.”

47. Lord Macnaghten stated as follows at p.318: -

5 “It is quite plain that the contract made by the offer of these debentures and the acceptance of that offer is nothing more or less than a contract to borrow and a contract to lend so much money payable by instalments. The essential character of the transaction is not altered either by the circumstances that the creditor in a certain event is to have the option of exchanging his position for that of a shareholder, or by the complicated nature of the arrangements made for the lender’s security.”

10 48. Since 1908 company law has provided for the possibility of specific performance of a contract to acquire debentures (thereby overriding that part of the decision in the *South African Territories* case). Section 195 Companies Act 1985 provides as follow:

15 “A contract with a company to take up and pay for the debentures of the company may be enforced by an order for specific performance”.

(now contained at section 740 Companies Act 2006)

49. The decision nevertheless, remains relevant to the meaning of “debt” in the context of an investment in a company. The continuing relevance of the decision on the debt point is referred to in *Palmer’s Company Law* at para 13.099.23.

20 “Where debentures are issued payable by instalments and the company has declared the debentures forfeited... Monies due for unpaid instalments prior to forfeiture do not constitute a debt....”

### ***A Subscription for Shares and Debt***

25 50. The Appellant argues that an agreement to subscribe for shares is, like an agreement to subscribe for debentures (as in the *South African Territories* case) not, in its nature a contract of purchase, but of investment: a subscriber “pays up” shares rather than “pays for” shares. By way of analogy with the *South African Territories Ltd* case, an agreement to subscribe for shares for a price payable by instalments does not make the subscriber a borrower from, or a debtor of the company.

30 51. In the VAT context, notwithstanding the width of the meaning “supply of services”, an issue of shares on a subscription is neither a supply of goods nor or services: *Kretztechnik AG v Finanzamt Linz* [2005] STC 1118: The AG put it as follows at paragraphs s 59 and 60:

35 “59. When a company issues new shares however, it is not selling any existing intangible property or any right over a fraction of its existing assets. It is increasing its assets by acquiring capital, and acknowledging the new shareholders’ rights as residual owners of a previously non-existent fraction of the increased assets which they have contributed in the form of capital.

40 60. Such a step defies categorisation as a supply of services by the company. From its point of view there is an acquisition of capital, not a supply, and thus no transaction capable of being taxed or

exempted from VAT. From the shareholder's point of view, it is an investment, an employment of capital, and not an acquisition."

52. This reinforces the point that a subscription for shares does not involve any extraction of profits, assets or value but on the contrary is an investment or employment of capital. Section 419 ICTA 1988 and the meaning of debt, in particular, should not, be construed in such a way as to apply to or include the liability incurred by the subscriber on a subscription for shares.

53. It is the Appellant's position that if the meaning of debt is considered in context, (*Marren v Ingles*), John Gray's subscription for shares in the Appellant did not give rise to a "debt" and no liability under s419 ICTA 1988 arose and that even if "debt" is given a normal meaning i.e., a meaning which does *not* take account of context, it is the Appellant's position that John Gray's subscription for shares in the Appellant did not give rise to a "debt" and no liability under s.419 CA 1988 arose (*South African Territories Ltd v Wallington*).

#### 15 ***A purposive Construction***

54. A purposive construction of s419 ICTA 1988 leads to the same conclusion; namely that John Gray's subscription for shares in the Appellant was not within the scope of s419 ICTA 1988.

55. The jurisprudence on the purposive approach to constructing tax legislation was recently summarised in *Astall v IRC* 80 TC 22 at paragraphs 20-35. Arden LJ said (at paras 27,):

"Lord Nicholls, giving the opinion of the Appellate Committee, described the correct approach to the interpretation of statutes for the purpose of determining whether a particular tax treatment was appropriate in the following terms:

25 "29. The *Ramsay case* [1982] AC 300 liberated the construction of revenue statutes from being both literal and blinkered. It is worth quoting two passages from the influential speech of Lord Wilberforce. First, at p 323, on the general approach to construction:

30 "What are 'clear words' is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded."

30. Secondly, at pp 323-324, on the application of a statutory provision so construed to a composite transaction:

35 "It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded."

40 32. The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether

5 the actual transaction (which might involve considering the overall  
effect of a number of elements intended to operate together) answered  
to the statutory description. Of course this does not mean that the courts  
have to put their reasoning into the straitjacket of first construing the  
statute in the abstract and then looking at the facts. It might be more  
convenient to analyse the facts and then ask whether they satisfy the  
requirements of the statute. But however one approaches the matter, the  
question is always whether the relevant provision of the statute, upon its  
true construction, applies to the facts as found. As Lord Nicholls of  
10 Birkenhead said in *MacNiven v Westmoreland Investments Ltd* [2003] 1  
[AC 311](#), 320, para 8: "The paramount question always is one of  
interpretation of the particular statutory provision and its application to  
the facts of the case."

15 56. The Appellant asserts that in applying tax legislation, the ultimate question for  
the Tribunal is whether the relevant statutory provisions, construed purposively, were  
intended to apply to the transaction, viewed realistically: Ribero PJ in *Collector of  
Stamp Revenue v Arrowtown Assets Ltd* [2003] HK CFA 46, (cited by Arden LJ in  
*Astall* at paragraph 27).

20 57. The purpose of s419 ICTA 1988 is to impose a charge to tax where profits,  
assets or value are extracted from a company without a charge to tax (being usually a  
charge to tax on distributions or dividends).

25 58. The charge to tax under s419 ICTA 1988 will apply on withdrawal of the profits  
or gains from an investment or on withdrawal of the investment in the company itself.  
Section 419 ICTA 1988 cannot, however, be construed as applying at the time at  
which a taxpayer makes an investment i.e. it is intended to apply to an outflow of  
funds or value from the company to the investor, not to an inflow of funds to the  
company from an investor.

30 59. The Appellant has referred at para 35 above to *Aspect Capital v HMRC* [2012]  
UK FTT 430 (TC) at para 221 and to the application of the "normal meaning of  
"debt"" in that case. In the context of discussing purposive interpretation, the Tribunal  
in *Aspect Capital* went on to say – paragraph 223 – that it was "not going to give a  
strained and unnatural reading of "debt" to compensate for a wide definition of  
participant..."

35 60. The Appellant's position is that, even construing the provision purposively; the  
correct approach should have been to give the term "debt" a meaning which depends  
on the context. Strained and unnatural meanings or readings would not then have been  
relevant.

Argument B

The meaning of "debt" should in this context be informed by company law

40 61. Under Argument B, the Appellant's position is that the meaning of "debt"  
should, in the context of s419 ICTA 1988 and the facts of this case, be informed by  
the company law analysis.

### ***Liability of a Member of a Company***

62. As a matter of company law (subject to certain statutory provisions relating to public companies which are inapplicable in the present case) a member of a company is bound to pay the full amount unpaid on his shares but unless the terms of issue so provide, he is not bound to pay up at once and is only bound in accordance with the Articles of Association of the company or in response to calls: s14(1) CA 1985, *Alexander v Automatic Telephone Company* [1900] 2 CH 56 and Palmer's Company Law para 6.201 "Liability of Shareholder to pay for shares".

63. The mere fact of becoming a member, whether as a subscriber to a memorandum or by a later subscription for shares, does not of itself impose any obligation on the member to make an *immediate* payment to the company in respect of the member's shares: *Alexander v Automatic Telephone Company*.

### ***Calls***

64. A liability arising under a call cannot mature into a debt until the call is made: *Whittaker v Kershaw* (1890) 45 Ch 320 at 326.

65. In *Re: Russian Spratts Patent Ltd* [1989] 2 Ch 149 Lindley MR said "...uncalled capital may be called property, yet it is property of a very peculiar description. After all it is not a debt. It is a right to make a call and create a debt".

66. To the extent to which money is paid by a shareholder in advance of calls, the shareholder is a creditor of the company: *Lock v Queensland Investment and Land Mortgage Company* [1896] AC 461. This decision reinforces the one in *Whittaker v Kershaw*, in that if, by reason of a prospective call, a shareholder were a debtor of the relevant company, advance payment of the call would discharge the debt but would not make the shareholder a creditor. Accordingly, the decision in *Lock* reinforces the position that a liability which arises under a call does not constitute a debt before a call is made. (The position is further reinforced by reg 21 of the 1948 Table A Articles of Association which provided for a payment made in advance of a call to bear interest:

"21 The directors may, if they think fit, receive from any member willing to advance the same, all or any part of the monies uncalled and unpaid upon any share held by him, and upon all or any of its monies so advanced (until the same would, but for such advance become payable) pay interest at such a rate not exceeding (unless the company in general meeting shall otherwise direct) 5 per cent annum, as may be agreed upon between the directors and the member paying such sum in advance".)

### ***Instalments***

67. Strictly, an instalment payable at a fixed date by the terms of issue of a share is not a call, but the Appellant's Articles of Association provide (as is standard in Table A article 16 Articles of Association) as follows:

5                   “Any sum payable in respect of a subscription for shares at a fixed date shall be deemed to be a call duly made and payable on the date on which it became due and that in the case of non-payment of an instalment, the provisions dealing with the consequences of non payment of a call shall apply.”

(Regulation 16 of the Appellant’s Articles of Association)

68. The effect of Regulation 16 of the Appellant’s Articles of Association is to provide that the liability to pay did not mature into a debt and that no debt was incurred by John Gray until the instalments (which are treated by Regulation 16 as  
10 calls) became due. The provisions of a company’s constitution, which includes the Articles of Association and the Shareholders Agreement (re *BSB Holdings Ltd* [1996] 1 BCLC 155) bind the company and its members to the same extent as if they were covenants on the part of the company and of each member to observe those provisions: s14 CA 1985. By virtue of this, the Articles of Association become a  
15 statutory contract of a special nature between the company and its members: *Scott v Frank R Scott (London) Ltd* [1940] Ch 794.

***Liability but not a Debt***

69. It is acknowledged that, on entering into the Shareholders Agreement, John Gray incurred a *liability* to make payment of the instalments, but the term liability  
20 embraces considerably more than the term debt and, as a matter of company law, that liability did not mature into a debt until each instalment (which was treated for company law purposes as a call) fell due for payment: *Whittaker v Kershaw* at 326 and Article 16, Appellant’s Articles of Association.

***Accounting Treatment***

25 70. The above analysis is not affected by the accounting treatment of John Gray’s subscription for shares in the Appellant.

71. It is an agreed fact that the sums payable by John Gray under the Shareholders Agreement were included in the Appellant’s balance sheets under the caption “Debtors”.

30 72. The requirements relating to the form and content of company accounts are derived from four sources: Companies Acts, Regulations issued by the Secretary of State, Accounting Standards, Listing Rules of the Financial Services Authority: *Palmer’s Company Law* 9.201.

35 73. Section 226 CA 1985 requires a company’s individual accounts to comply with the provisions of Schedule 4 as to the form and content of the balance sheet (Schedule 8 provides (i.e. exemptions) the formats for small companies: s246 CA 1985). Schedules 4 and 8 CA 1985 contain balance sheet and statement of profit and loss formats and notes to them.

40 74. “Called up share capital not paid” is shown in the balance sheet formats (of which there are two formats, Format 1 and Format 2, in each of Schedules 4 and 8 CA



1985) under the caption “A”. (The meaning of “called up share capital” is explained at paragraph 91-98 below).

75. “Debtors” is shown in the balance sheet formats under sub-heading “II” of caption “C”.

5 76. Note (1) to the balance sheet formats in Schedule 4 CA 1985 relates to “called up share capital not paid” and provides as follows:-

“(Formats 1 and 2, items A and C.II.5)

This item may be shown at either of the positions given in Formats 1 and 2.”

10 77. It follows that inclusion of unpaid share capital within “Debtors” is optional and can neither determine nor to any extent influence the nature of the liability to pay unpaid share capital as a matter of law. In particular, it cannot follow from the inclusion of unpaid share capital within “Debtors” that unpaid share capital is “debt” for the purposes of s419 CTA 1988, where debt must take its meaning from the  
15 context: *Marren v Ingles*.

78. Items such as “preference” shares may be included in the balance sheet under “Debtors” because of their economic characteristics (which prevent them being equity share capital as defined in s.744 CA 1985) but, as a matter of law, preference shares are shares (which are paid dividends) and not debt (on which interest may be paid).  
20 Unpaid share capital is simply another example of the inclusion within a balance sheet caption (in this case “Debtors”) of an item which does not correspond to the true legal nature of the caption.

79. Further, the nature of John Gray’s obligation was, as a matter of law, determined by events on 20 November 2000 (the date on which the Shareholders Agreement was entered into) and cannot be affected or varied by the way in which the Appellant subsequently accounted for the instalment payment in its financial statements  
25

### ***The Significance of Discounting***

80. In its financial statements for each of the years ended 31 December 2000 and  
30 until 2005 the sums referred to in Schedule 4 to the Shareholders Agreement were included in the Appellant’s balance sheets at their respective net present values in all relevant years.

81. Discounting the sums to net present values is inconsistent with the sums being debts which were due from the date at which the Shareholders Agreement was entered  
35 into.

82. In the circumstances, it is the Appellant’s position that this aspect of the accounting treatment supports the position that it did not incur any debt on entering into the Shareholders Agreement: it does not support HMRC’s position to the contrary.

83. In any event, as noted in paragraph 81 above, the nature of John Gray's obligation was, as a matter of law, fixed on 20 November 2000 and cannot be varied or affected by the Appellant's subsequent accounting treatment.

***The Significance of the Definition of "Called up Share Capital" in CA 1985***

5 84. The balance sheets format in Schedule 4 and 8 CA 1985 refer to "called up share capital not paid". Uncalled share capital is not included as an item in the balance sheet formats set out in Schedules 4 and 8 CA 1985.

85. "Called up share capital" is defined in s737 CA 1985 as follows:

10 "“(1) In this Act, "called up share capital", in relation to a company, means so much of the share capital as equals the aggregate amount of the calls made on its shares (whether or not those calls have been paid), together with any share capital paid up without being called and any share capital to be paid on a specified future date under the articles, the terms of allotment of the relevant shares or any other arrangements for payment of those shares.

15

(2) "uncalled share capital" is to be construed accordingly.

(3) The definitions in this section apply unless the contrary intention appears.”

20 This provision envisages the obligation to pay for shares arising either on the company making a call or by way of fixed timetable: *Palmer's Company Law* 4.012.

25 86. HMRC suggests that the effect of the Shareholders Agreement was to make a call on the shares acquired by John Gray on 20 November 2000 (the date of execution of the Shareholders Agreement). It is inferred by the Appellant that this must be said to follow from the definition of "called up share capital", which includes share capital to be paid on a specified future date under the terms of allotment or any other arrangements. HMRC goes on to assert that a single debt for the full amount of John Gray's subscription price arose on the execution of the Shareholders Agreement and that the debt did not arise on the dates on which the instalments respectively became due for company law purposes.

30

87. The Appellant's position is as follows:

35 i. it cannot follow from the definition of "called up share capital" that a call was made on execution of the Shareholders Agreement. Section 737 CA 1985 is a definition section: the definition is relevant to the operation of, for example, Schedules 4 and 8 CA 1985. Section 737 CA 1988 is not, however, a deeming provision from which consequences might be considered naturally to follow.

35

40 ii. The balance sheet formats are inconsistent with there being a debt for the unpaid share capital from the date of subscription. As explained above, the balance sheet formats provide for the possibility of including

“called up share capital not paid” under “debtors” or in a separate category, implying that there is no debt as a matter of law. On the other hand, if there was clearly a debt as a matter of law (as HMRC suggests) the balance sheet formats could not provide for this optional treatment.

5           iii. That except where the articles expressly so provide, the sums payable to the company on application or allotment for shares are not to be regarded as calls for the purposes of the rules regarding calls (such as interest and forfeitures): *Croskey v Bank of Wales* (1863) 4 Giff 314).

10       88. Accordingly the Shareholders Agreement did not have the effect of making a call on the shares acquired by John Gray on 20 November 2000 nor did any debt arise on the execution of the Shareholders Agreement on 20 November 2000.

### Argument C

#### John Gray was not a “participator”

15       89. The meaning of “participator” for the purposes of s419 ICTA 1988 is provided by s417 (1) ICTA and set out at paragraph 31 above.

90. John Gray did not hold any shares or interest and was not entitled to acquire any shares or interest in the Appellant before execution of the Shareholders Agreement.

20       91. If, as the Appellant asserts is not the case, John Gray incurred a debt within the meaning of s419 ICTA 1988 on entering into the Shareholders Agreement, he incurred that debt by the very transaction that made him a participator in the company. Section 419 ICTA 1988 does not apply to a person unless he is a participator when the loan is made to (or debt is incurred by) him.

25       92. The position of a “new” shareholder in a company and the application of s419 ICTA 1988 is analogous to the position of a company selling assets into a group of companies and obtaining consideration in the form of an issue of shares and the application of s171 TCGA 1992 which provides as follows:

“(1) Where –

30           (a) a company (“Company A”) disposes of an asset to another company (“Company B”) at a time when both companies are members of the same group, and

35           (b) the conditions to subsection (1A) are met, Company A and Company B are treated for the purposes of corporation tax on chargeable gains as if the asset were acquired by Company B for a consideration of such amount as would secure that neither a gain nor a loss would accrue to Company A on the disposal”

93. This rule does not apply where an asset is transferred from one selling company (“S”) to another purchasing company (“P”) in consideration for an issue of shares to S of such a number that makes S and P members of the same group as defined in s170

TCGA 1992. The reason is that the disposal does not take place “when both companies are members of the same group”.

5 94. HMRC will assert that the use of the present tense “is”, does not exclude simultaneity. The use of the present tense excludes simultaneity in s171 TCGA 1992; and it is the Appellant’s submission that it likewise does so in s419 ICTA 1988. In both provisions shares will be issued in return for consideration. In the context of s171 TCGA 1992, S and P are not members of the same group of companies during the course of the transaction and, in the context of s419 ICTA 1988, the investor is not a participator during the course of the transaction. In this case John Gray is not a  
10 participator in the Appellant at the moment at which the Assumed Debt is incurred.

15 95. Section 422 ICTA 1988 contains provisions which extend the operation of s419 ICTA 1988 to cases described within it which would not fall within the basic provisions of s419 ICTA 1988. It is implicit from s422 ICTA 1988 that the scope of s419 ICTA 1988 has been given detailed consideration by the legislature and that where the legislature has wished to extend the operation of s419 ICTA 1988 beyond the field of operation created by s419(1) ICTA 1988, it has done so expressly. If parliament had wished or intended s419 ICTA 1988 to apply to circumstances where a loan (with its extended meaning) is made to an individual who *is to become* a participator, it would have done so in the way that it has provided for extended  
20 applications where it has otherwise seen fit in s422 ICTA 1988 (and, indeed by the 1969 amendment – inserting s419(2) ICTA 1988 – described above).

25 96. Given the s419 Mischief, it is entirely logical that s419 ICTA 1988 should not apply to the transaction by which an individual makes an investment in a company and becomes a participator: such an individual is, as asserted above, introducing capital rather than withdrawing property, assets or value from the Company.

97. HMRC will refer to the s419 Mischief (in narrower terms than the Appellant has acknowledged to be the s419 Mischief) and states that it would frustrate the intention of Parliament and the purpose of the enactment if s419 could be frustrated by so simple and transparent an expedient as simultaneity.

30 98. The Appellant’s position is that this simply does not follow. The s419 Mischief is focused on the extraction of profits, assets, or value by participators. It is not focused on the time at which an individual becomes a participator and, as already explained, it is entirely consistent with the s419 Mischief that s419 ICTA 1988 should not apply to an incoming investor.

35 ***Participators and Control***

99. HMRC will argue that John Gray acquired control of the Appellant on entering into the Share acquisition agreement. Section 419 ICTA 1988 has nothing to do with acquiring control. Control is irrelevant.

40 100. The rationale behind Argument C is consistent with the Appellant’s position that the term “debt” in s419 ICTA 1988 should not be construed in such a way as to apply to a transaction whereby an individual invests into a company. A new investor

is not a participator before he makes his investment and rules directed at extraction of profits, assets or value by participators from their investment should simply not be construed as applying on the making of an investment.

### *Aspect Capital*

5 101. In *Aspect Capital*, it was conceded that individuals who subscribed for shares were participators by reason of existing holdings of shares. It was, however, apparent that the Tribunal considered that Argument C could have been available to the Appellants in that case had they not already been participators: paras 90 and 223 of the decision. It is the Appellant's position that Argument C is available to it because  
10 John Gray was not a participator in it at the time at which the Assumed Debt was incurred.

#### Summary of Appellant's position

102. John Gray's subscription for shares for payment in instalments did not give rise to a debt within the meaning of s419 ICTA 1988 (Argument A). Accordingly, no  
15 liability has arisen under s419 ICTA 1988 and the Appellant's appeals against the Assessments and the Alternative Assessment should be allowed in full.

103. Further, an individual who subscribes for shares in a company as an incoming shareholder is not a participator in the company for the purposes of s419 ICTA 1988 at the time at which he subscribes for the shares and incurs a liability to pay for them  
20 (Argument C). Accordingly, if the Appellant is unsuccessful in its Argument A, but is successful in Argument C no liability has arisen under s419 ICTA 1988 and the Appellant's appeal against the Assessments should be allowed in full.

104. If, contrary to its primary position, the Appellant does not succeed in Argument A and Argument C but it is successful in its Argument B, no liability arises under  
25 s419 ICTA 1988 in the period ended 31 December 2000 and its appeal against the Assessment should be allowed in full. A liability under s419 ICTA 1988 will, however, have arisen in the period ended 31 December 2001, its appeal against the Alternative Assessment should be dismissed and the Appellant will be liable to pay the amount which has been agreed to be the collectible amount for that period.

#### 30 The Respondents case

105. The Respondents' case in outline is that:

- i. Section 419(1) includes within the definition of 'loan', the case where a participator incurs a debt to the close company.
- ii. A subscriber incurs a debt to an issuing company where the shares are  
35 allotted fully paid and called up, and the subscription price is not paid immediately on allotment. In these circumstances the subscriber 'incurs a debt' with the meaning of s419(2)(a)

iii. Where the subscription price becomes due and owing on entering into an agreement to subscribe for shares but the consideration is payable by instalments, the subscriber is a participator and incurs a debt within s 419(2).

#### Argument A

5 The unpaid subscription price is an “investment” not a “debt”

106. The Respondents submit that the appeal turns on meaning of “incurs a debt” in 419(2), in the context of the facts of this matter.

107. HMRC referred us to *Grant v Watton*, (IoT) [1999] STC 330 ChD. 1999, which they say reflected, established law that, under an agreement to subscribe for shares for a stated price, failure to perform by making payment of the subscription price makes the subscriber a debtor of the issuing company.

15 In that case the expenses of an estate agency were paid by a service company, of which the estate agent was the controlling director. The revenue issued assessments charging tax in respect of these payments. The director appealed contending that the services fees did not fall due for payment until such time as the company’s accountants notified the company and the director of the final annual calculation of the charge. The Special Commissioners rejected this contention, finding that ‘the amount of the fee was initially and contractually agreed to be the amount of the relevant costs plus a mark-up of one ninth of the relevant costs’. The effect of the arrangement was that the service company was extending credit to the director. Pumfrey J held that the words ‘any form of credit’ in ITEPA 2003 s173(2) should be construed widely and given their ordinary and natural meaning. There were no grounds for treating the credit as being deferred until the date when the service company actually paid a particular supplier.

25 108. A debt arises or is incurred on acceptance of the offer, which occurs on formation of the contract. Mr Gray became a debtor of the Appellant on entering into the Shareholders Agreement.

30 109. On a proper interpretation of the documentation the intention of the parties is that the whole subscription price (i.e. all instalments) is called on the date of signature of the subscription agreement. The subscription agreement is in the nature of a call and no further call is required. Therefore on date of signature the whole subscription price is a debt which is due and payable, albeit in the future on fixed instalments.

35 110. The Appellant’s description of the mischief; “to counter tax avoidance by participators in close companies and specifically, “avoidance by the untaxed extraction of profits, assets or value,” is not disputed, but HMRC take issue with the Appellant insofar as the Appellant suggests that:

- i. “Extraction” has the literal meaning of an act of removal of company assets or an act to transfer ownership, of a material asset, whether it be stock, or an act to debit an account of the company while crediting an account of a

participator. The Respondents contend that “extraction” can cover both an act and an omission, including the forbearance of a debt.

- 5           ii.    There is something absurd in the notion of a person being both investor and debtor. The Respondents say that, with closely held companies and partnerships, it is not unknown for members or partners to be both investors and debtors.

111. The wording of the statute does not suggest that it should be limited to specific types of debt. If Parliament had wanted s419(2) to be limited, it would have been worded accordingly.

10   112. On 20 November 2000 Mr Gray and the Appellant entered into the share subscription agreement under which Mr Gray subscribed for 4,808,880 shares of 45.12697p each and the Appellant issued and allotted 4,808,880 shares to Mr Gray, fully issued. The subscription price was therefore £2,170,102. Pursuant to the share subscription agreement, Mr Gray also acquired control of the Appellant.

15   113. The Appellant performed under the 20 November 2000 share subscription agreement following which Mr Gray enjoyed the benefits of the shareholding, including:

- i.    The potential to receive dividends and to dispose of his shares;
- ii.   To attend shareholders meetings, receive annual accounts, and to vote;
- 20       iii.   To exercise control, to act as managing director, to appoint staff, and to change the focus of the business.

114. Mr Gray failed to perform by paying the subscription price. From 24 November 2001 until on or about 25 September 2005, Mr Gray was in breach of the 20 November 2000 share subscription agreement, albeit subject to accrued interest on the late payments.

25

115. The fact that from an economic perspective, by his subscription, Mr Gray made an investment of £2,170,102 in the Appellant and did not acquire the shares for ‘consumption’ is not necessarily relevant. Furthermore, the economic classification of a share subscription contract as an investment contract does not translate into a jurisprudential classification as an “investment contract.”

30

116. The case of *Kretztechnik* does not assist the Appellant beyond suggesting that a subscription for new shares is, in economic terms, likely to be an investment. That point is not disputed. However *Kretztechnik* turns on VAT-peculiar definitions (of an “economic activity”, a “taxable supply” and of “consideration”, etc.) and also technical considerations arising out of the VAT system of deduction (input tax credit) and the VAT principle of fiscal neutrality (non-distortion of the markets for goods and services etc.). *Kretztechnik* tells us nothing about the treatment of a breach by non-payment of a share subscription agreement, whether for VAT purposes or corporation

35

tax purposes .It does not apply to the acquisition or disposal between two investors of existing shares.

5 117. What is relevant is the salient fact that Mr Gray failed to make that investment (payment), and the Appellant tolerated that breach having itself performing under that agreement.

118. The Appellant’s own definition of the s419 mischief, “avoidance by the untaxed extraction of profits, assets or value”, is apt to cover a very wide range of factual scenarios which amount to either a loan or to the creation of a debt, including;

- 10 i. The obvious case of a loan, whether formally by way of a written loan contract, or informally by way of an overdrawn director’s loan account.
- ii. A debt, arising by the granting of credit, through the mechanism of the toleration of non-payment by a participator of the price due under any contract under which the company has performed, whether that contract be for goods sold services rendered, or for shares subscribed for and allotted.
- 15 iii. A debt, arising in any other form, for example by virtue of a director’s defalcations as made clear in *Stephens v Pittas* [1983] STC 576 at 14

20 “We are fortified in our view by the fact that s75 was amended in 1969 so as to bring into account, in addition to loans or advances, any debts incurred to the company. In our opinion the sums which Mr Pittas abstracted from the company did involve his incurring a debt or debts to the company,”

25 119. The authority for the Appellant’s argument is the case of *South African Territories Ltd v Wallington* (SAT). The debenture holder contracted to make payments to the issuing company on signature of the debenture and then on instalments. The debenture holder defaulted on the instalment payments. SAT sued for specific performance of the debenture contract, but not for damages for breach of the debenture contract.

30 120. SAT is distinguishable from this appeal on the facts and the principles. In SAT, the jurisprudential nature of the debenture subscription agreement was one of loan (from the subscriber-debenture holder to the company), while in this appeal the jurisprudential nature of the share subscription agreement is an agreement to take shares. In SAT there was no debt because there was a loan contract not a sale contract.

35 121. In SAT the court was faced with an attempt to dress up a loan contract as a sale contract, to subvert the procedural rule against specific performance by presenting a loan agreement as a form of incorporeal property. In SAT, the court maintained the integrity of the common law rule that a suit for specific performance is not available in the case of breach of a loan agreement. SAT tells us that a subscription agreement for debentures is a loan agreement not a purchase and sale agreement. It is obvious that a share subscription contract is not a loan contract. There is no reason to suggest



that a share subscription agreement should not to be treated like an agreement for purchase and sale.

122. SAT is therefore of no assistance to the Appellant in identifying any mischief. In an effort to overcome this, the Appellant argues that a contract to subscribe for shares is a contract to invest money in the issuing company and similar to a debenture contract, in the sense that no debt arises on non-payment of the subscription price.

123. The Appellant's argument fails because:

- i. Investment occurs if and when the subscription price is paid to the issuing company, (rather than when the subscription agreement is signed). Investment implies a return on capital. The return on a share takes the form of dividends or to capital appreciation (when shares are sold). A participator who fails to pay over the subscription price will not enjoy a return on investment.
- ii. The shareholder is a debtor not an investor, while as the issuing company tolerates non-payment). So the facts of this appeal are as much within the scope of the s419 universal mischief as are the facts of *Watton's case*.
- iii. A share subscription contract is not comparable in any relevant way to a debenture subscription contract (a loan contract). More specifically, there are no points of similarity which are relevant to "chargeability" under s419(2). While a share certificate like a debenture note is a form of incorporeal property, a reciprocal promise to pay the subscription price for a share is a debt (subject only to possible procedural considerations under the subscription agreement or the articles of association), and the company may sue for that debt. A promise to grant credit (to pay over the loan capital) is not ordinarily a debt and so neither a cause for debt nor for specific performance is competent. A debenture holder is a loan creditor of the company. A debenture holder will ordinarily recover their capital on the redemption date, while in the meantime with interest at the coupon rate. The company has the temporary use of the debenture holder's capital. In the case of shares, the money 'invested' becomes the company's money.

124. The toleration of the breach (of non-payment) is in economic terms the granting of credit. In order to transfer untaxed money to a participator, the performing supplier-company is tolerating the non-performance of the agreement. It is no different to the "avoidance by the untaxed extraction of profits, assets or value" as referred to by the Appellant.

125. In the share subscription context, it has been held that the issuing company becomes the debtor of the subscriber who has paid the subscription price (has performed or tenders performance). *Blackburn & anor v RCC* [2009] STC 188 CA, [2008] EWCA Civ 1454, at para 28.

“Once the company had refused to allot the shares, the £96,000 would become repayable, and, at that point, I would have thought that it could well be characterised as a debt, but not until that point.”

5 The above dictum suggests that a share subscription agreement is an ordinary bilateral contract of purchase and sale, and that by parity of reasoning, the breaching subscriber becomes the debtor of the issuing company, which has performed (or tenders performance).

126. In *Tuffnell & Ponsonby’s case* (1885) 29 ChD 421 at 426 per Chitty J. a share subscription case, the court said

10 “There is no difference, as has been often pointed out, between a contract to take shares and any other contract. What is termed ‘allotment’ is generally neither more nor less than the acceptance of the company of the offer to take shares. ....To my mind there is no magic whatever in the term ‘allotment’ as used in these circumstances. It is said that the allotment is an appropriation of a specific number of  
15 shares. ....it constitutes a binding contract under which the company is bound to make a complete allotment of the specified number of shares, and under which the person who has made the offer and is now bound by the acceptance is bound to take that particular number of shares.”

127. There is no reason why the ordinary rules of contract should not apply. In  
20 *Tuffnell’s case* the court applied the ordinary rules of contract formation, offer and acceptance. There is no basis for the suggestion that the ordinary rules of contract do not apply to other aspects of the contractual relationship, such as time for performance or remedies for breach. One may modify the court’s observation as follows; there is  
25 an offer to take shares at a particular subscription price, and an acceptance of that offer. There is no magic in the corporate investment or share subscription context. Ordinarily, if there is performance by only the one party to a bilateral agreement, then the defaulting party becomes the debtor of the performing party

***Debt in section 419(2) to bear its ordinary meaning, for all causes***

128. Section 419(2) was introduced by FA 1969. The purpose was to broaden the  
30 scope of avoidance activities caught by s419. The word “debt” in s419 is not defined. The ordinary meaning of debt is ‘what is owing’; ‘a sum of money owed’. And ‘to owe’ means ‘be bound to pay, be indebted or under an obligation to pay an amount of money to someone’.

129. In its ordinary meaning then the essential precondition for the existence of a  
35 debt is the existence of an obligation to pay. An obligation arises on the date on which the contract creating it is concluded (by acceptance of the offer), or on the effective date under that contract if earlier than the date of conclusion. A debt may be payable immediately or in the future. On its ordinary meaning, the concept “debt” bears no qualification by reference to “maturity” (i.e. due date for payment). There is no  
40 requirement that the date for payment has passed, or even as to the need for a certain date for payment. It does not arise on the date or dates that the debt or part thereof has agreed to become payable.

130. Depending on the context in which it is used (whether in an enactment or in a contract), the word “debt” may bear a wide or a narrow technical meaning. However in s419(2) “debt” must bear a wide meaning. The need for a wide meaning is illustrated by the case law examples. These cover a wide and evolving range of operative and jurisprudential scenarios, ranging from collusion to non-collusion, contract to theft, and written formality to oral informality

131. In the context of non-arm’s length arrangements involving investors, or for example between employers and employee benefits trustees, contingency, maturity and risk (of non-recovery) are peculiarly features within the control of the contracting parties. It would defeat the intention of parliament and the purpose of the enactment if s419 could be frustrated by the simple expedient of reference to maturity and risk.

132. The potential balance prejudice indicates that a wide meaning is appropriate. The balance must be drawn between the interests of the state and the exchequer on the one hand, and the interests of the taxpayer on the other.

15 ***Instalment plan in the subscription agreement creates a debt***

133. Argument A is that an agreement to subscribe for shares for a price payable by instalments does not make the subscriber a borrower from nor a debtor of the company. It does not distinguish between a subscription agreement in which, as a matter of construction:

- 20 i. The full amount is due and owing on signature but payable in specific amounts on stated future dates (fully paid and called up); and one in which
- 25 ii. The full subscription price is not due and owing on signature but specific amounts are due owing and payable on stated future dates (part paid/uncalled).

134. Payment by an instalment plan suggests the existence of a debt as contemplated in s419(2)(a) plan amounts to the extension of credit. A creditor is one to whom a debt is owing, one who gives credit for money or goods. The instalment plan in Schedule 4 to the November 2000 agreement amounts to the extension of credit by the Appellant to Mr Gray. This does not postpone the date on which the debt arises, it merely provides for the rate at which the existing debt is to be discharged.

***Probative value of the annual financial statements***

135. Accountants seek to report the substance of transactions, rather than rigidly following the legal form. This is consistent with UK ‘Generally Accepted Accounting Principles’ (GAAP), paragraph 46 states:

“Paragraph 14 of the FRS sets out general principles for reporting the substance of a transaction. Particularly for more complex transactions, it will not be sufficient merely to record the transaction’s legal form, as to do so may not adequately express the commercial effect of the arrangements.

Notwithstanding this caveat, the FRS is not intended to affect the legal characterisation of a transaction, or to change the situation at law achieved by the parties to it.”

136. In *Aspect Capital Ltd v RCC* the First tier Tribunal said:

5 “212. Whether something is a receivable for accountancy purposes is a very different question to whether it is a debt for legal purposes. We understand that whether something is shown as a receivable in accounts will depend on whether it is more likely to be paid than not. Whereas, on the rules as discussed above, we could envisage a receivable that is very likely to be paid but is not a debt (e.g. a chose in  
10 action that is virtually certain to be upheld in court) and a debt that is very unlikely to be paid (e.g. a debt where a waiver event is very likely to occur). The receivable would not be a debt and the debt would not be a receivable.

213. Therefore, it is irrelevant that the facilities under the UK Facility Agreements were treated as receivables (more likely to be paid than not) by the auditors. We also  
15 are uninfluenced by whether or not the auditors described the facilities as loans or facilities. Even if, which must be unlikely, the auditors were seeking to describe the legal effect of the UK Facility Agreement, their view of the law is irrelevant to the Tribunal.”

137. The annual accounts are of course not always irrelevant, or to this appeal specifically. There may be possible inferences (e.g. as to the state of mind of the directors as regards their understanding of their rights and obligations under agreement, etc.), which may be drawn from the annual accounts (whether GAAP-compliant or not, whether otherwise relevant to the legal issues or not). Mr Gray signed the annual financial statements for the relevant years, in his capacity as a  
20 managing director of the company.  
25

138. Notwithstanding the above caveat, the Respondents submit that the accounts of the Appellant correctly reflect the amount due on the shares as a loan. The Appellant’s annual financial statements in the years between 31 December 2001 and 31 December 2004 reflect the fact that Gray was indebted to the Appellant and show  
30 the net present value on the respective payment dates (as at the balance sheet date) of the amount due. Clearly therefore Mr Gray ‘incurred a debt’ with the meaning of s419(2)(a).

### Argument B

#### The unpaid subscription price is not a “debt” but a “liability”

35 139. The Appellant’s ‘argument A’ is that the meaning of ‘debt’ must be informed by the company law principle that a member of a company is only bound to pay for shares in accordance with the articles of association, or in response to calls. Mere membership as a subscriber gives rise to a potential liability to pay, but does not create a debt or an obligation to make immediate payment.

40 140. Subject to the terms of any agreement to take and allot shares the power to make a call is in Article 16 of the articles of association. Article 16 of Table A states:

“An amount payable in respect of a share, on allotment or at any fixed date, whether in respect of nominal value or premium or as an instalment of a call, shall be deemed to be a call ....”

5 141. The Appellant says that under Article 16, each instalment under the subscription agreement is a separate call so Mr Gray only became a debtor on each instalment date for that instalment amount. Only when the obligation under the articles to pay became effective, did the liability mature into a debt. Without a call there is no debt and without a debt there is no s419(2) liability.

10 142. The Respondents submit that the Appellant relies on *Whittaker v Kershaw*, old case law in company law, which suggests that there is no debt until there is a call under the articles. However *Whittaker’s case* can be distinguished. *Whittaker* only applies where, in terms of the subscription agreement, the subscription agreement is to be part paid, with the balance due only on a call made under the articles of association. But in any situation where a call cannot or need not be made, *Whittaker* cannot apply. More specifically, *Whittaker* cannot apply where the terms of payment  
15 are governed by the subscription agreement and not by the articles of association.

143. *Whittaker*, like *Alexander* reflected contemporaneous business practice. At that time, company flotations relied primarily on financing from subscribers, rather than from financial institutions and subscribers contracted to make themselves liable for a maximum sum. Modern business practice is different. Either payment in full is  
20 required at the outset, or payment is made in instalments.

“Originally, the situation was that the liability of the shareholder was contingent upon a call being made. In modern practice that is rarely adopted. In modern practice, private companies usually allot shares on terms that  
25 require payment at the outset.” [Palmer on Company law, para 6.203 (instalments and calls, modern practice)].

144. This change in business practice considerably restricts the relevance of cases like *Whittaker* and *Alexander*.

30 145. Section 16 of CA 1862 (with which *Whittaker* was concerned) was partly rewritten in s14(2) and 508 of CA 1985. Section 14(2) of the Companies Act 1985 (company formation, registration and its consequences, effect of memorandum and articles) reads:

“Money payable by a member to the company under the memorandum or articles is a debt due from him to the company...”

35 146. Section 508 of the Companies Act 1985 (winding up of companies, nature of contributory’s liability) reads:

40 “The liability of a contributory creates a debt (in England and Wales in the nature of [an ordinary contract debt]) accruing due from him at the time when his liability commenced, but payable at the times when calls are made for enforcing the liability.”

147. It is clear that the interpretation of s16 in *Whittaker* was codified in s14(2) and 508. But *Whittaker* should not be read as stating a universal rule that in every case there is no debt due to a company until a call is made.

5 148. The Respondents' understanding of the law is reflected in the company's accounts: Share capital in respect of shares allotted to Mr Gray are reflected as called up capital. The Appellant's accountants were aware that the subscription price was due owing and payable in full, and aware too that instalments, at the various reporting dates, were either still to be reached or had passed unpaid.

***Debt arises on acceptance not on the instalment date***

10 149. Clause 19ii of the November 2000 agreement states that the nominal value of the 4,808,880 'B' ordinary shares allotted to Mr Gray will be £0.4512697 per share. Clause 19ii expresses the arithmetic par value of the single tranche of shares in a single sum, £2,170,102. Clause 20 of the November 2000 agreement records that in  
15 consideration for the allotment to him of the single unitary tranche of 4,808,880 'B' ordinary shares, Mr Gray will pay to the Appellant the nominal subscription price of those shares, being the sum of £2,170,102. The agreement refers to a single subscription price.

150. The instalment plan in Schedule 4 of the agreement was merely the division of that single global debt into smaller amounts for the purpose of payment at intervals.  
20 An instalment plan is merely a mechanism for extending credit, or making a loan.

151. Interpreted purposively or commercially, it is clear that the party's intention must have been to record that the full amount of the subscription price was due and payable on signature of the subscription agreement. Had the parties adverted to it, the parties would have agreed that a debt had been incurred and no further call was  
25 required. That must be so, because as rational businessmen the founding shareholders would not have contracted to give Mr Gray control (an explicit purpose of the subscription agreement), and at the same time have contracted to place themselves in a situation where Mr Gray as subscription debtor and new controlling shareholder had the power to avoid ever paying for the shares by the simple expedient of using control  
30 to block any attempt to make a call. The subscription agreement made the subscription debt immediately due, and the instalment plan merely recorded the future dates for payment.

***An Instalment plan is a call***

152. The Respondents say that an instalment plan is a call. Modern practice is to  
35 regard an instalment plan (such as that contained in Schedule 4 to the November 2000 agreement) as an immediate call for the purposes of the articles. Mr Gray was on 20 November 2000 indebted in the full amount of £2,170,102. The November 2000 agreement itself amounted to a call (as opposed to each instalment being a call). On signature on 20 November 2000, Mr Gray's shares were issued, allotted, and called.

40 153. Section 737 of CA 1986 'Called-up share capital' (rewritten as s547 of CA 2006) reads as follows:

5 (1) “In this Act, ‘called-up share capital’, in relation to a company, means so much of its share capital as equals the aggregate amount of the calls made on its shares (whether or not those calls have been paid), together with any share capital paid up without being called and any share capital to be paid on a specified future date under the articles, the terms of allotment of the relevant shares or any other arrangements for payment of those shares.”

154. Under s737 “called-up share capital” therefore includes share capital and share capital payable under an instalment plan in an agreement to take shares.

10 155. The November 2000 share subscription agreement describes the ‘B’ ordinary shares as “... fully unconditionally and irrevocably issued.” The phrase “fully paid” is not used in the subscription agreement but section 738(2) CA 1986 provides that:

“a share in a company is deemed paid up in cash ... if the consideration for the allotment or payment up is ... an undertaking to pay cash to the company at a future date.”

15 156. The accounting manuals issued by the “big four accounting firms” do provide some guidance. This “big four guidance” does not constitute binding GAAP. Nevertheless, the guidance does provide assistance to accountants to help them interpret the relevant parts of companies legislation.

20 157. The Deloitte UK GAAP guidance refers to the statutory definition of called up share capital, and then goes on to state:

25 section 2.1 “It follows from the definition of called-up share capital that a debtor will be recognised in two circumstances firstly when a ‘call’ has been made on the shares but it has not yet been paid; and secondly when shares have been issued on terms that payment will be made on a specified future date under the articles, the terms of allotment or other arrangements.

158. The PricewaterhouseCoopers GAAP guidance states:

section 23.27 “Equity shares are normally recorded as paid-in capital in the balance sheet at the net proceeds of issue, when the proceeds of issue are received or receivable”.

30 section 23.46 “Under the Act, share capital is ‘called up’ or ‘paid up’ not just when the cash is received, but when there is a schedule of payments due on fixed future dates or there is an undertaking to pay cash to the company at a future date. ‘Paid up’ share capital may, therefore, surprisingly, be unpaid. Uncalled share capital is to be construed accordingly. A share in a company is deemed paid up in cash if one of five types of specified consideration has been received.

35 section 23.36 “If the shareholder is contractually obliged to pay, and they have full rights to dividends, the issuer recognises a receivable for the outstanding future receipts (discounted, if material) at the issue date of the shares, with a corresponding entry to paid-in capital (share capital/share premium). The receivable is a financial asset, as the issuer has a contractual right to receive cash from the shareholder.”

section 23.38 “Under the model articles (Table A), dividends are paid according to the amounts paid up on shares, as defined by the Act. If there is a fixed payment schedule for calls or an undertaking to pay calls to the company at a future date, companies following the model articles recognise a receivable for the outstanding issue proceeds.”

5 159. The PricewaterhouseCoopers guidance for company secretaries states:

Section 8.7.1 “... shares may be paid up (in relation to their nominal value and any premium) in consideration of an undertaking to pay at a future date...”

10 Section 8.7.4 “In essence, if the shares are issued fully paid in consideration of an undertaking to pay at a future specified date, then the company will have a contractual right to sue the subscriber for the price. ... Where the shares are issued nil or part paid, there is no debt due from the shareholder to the company until the company calls for payment to be made by the shareholder, known as a ‘call’.”

160. The Ernst & Young GAAP guidance includes:

15 “At section 3.1.1 an example of a company that issues 1 million 5p shares for £1 million payable in five years’ time, using an assumed discount rate of 5%. The guidance given for the example states that “... the fair value of the consideration received would for accounting purposes generally now be regarded as the net present value of £1 million receivable in five years’ time – assuming a discount rate of 5%, £783,526.” The guidance goes on to conclude that the accounting treatment would be  
20 to record a debtor of £783,526 at issue date; and that debtor would then be accreted to £1 million over five years on a constant rate of return basis.”

***“Fully paid” in the annual financial statements***

161. The Appellant’s annual financial statements for ape 31 December 2000 state that the shares were “Allotted, called up and fully paid.” The Appellant’s annual  
25 financial statements for ape 31 December 2001 state that the shares were “Allotted, called up and fully paid.”

162. One can also look at the treatment of the subscription agreement in the annual financial statements. By their very nature, the annual financial statements serve as a reliable indication of the contemporaneous commercial interpretation of the  
30 subscription agreement by both the Appellant and Mr Gray as subscriber of the subscription agreement.

163. It is clear that the annual financial statements must reflect the substance of the transactions entered into by the company. That is, the annual financial statements must be based on a proper interpretation of the relevant contracts. And only if in their  
35 legal form those contracts do not reflect the substance of the transactions, which they purport to regulate, then in drawing up the annual financial statements the contracts must be ignored and the substance of the transactions must be reported. There is no suggestion that the August 2000 subscription agreement does not reflect the substance of the subscription and allotment transaction.

40 ***The instalment plan is a directors’ resolution to call***



164. In the alternative, if a valid call is required, then the instalment plan in the November 2000 agreement is to be regarded as a valid call.

5 165. The November 2000 agreement is unusual in that it has been signed by all the shareholders (it is signed by all the directors), rather than by a director mandated to sign on behalf of the company. The effect of this peculiarity is that the November 2000 agreement amounts to a resolution. It is in effect a directors' written resolution under the articles of association and as a call notice, the November 2000 agreement was effectively served on Mr Gray on its execution.

10 166. The mere existence of an instalment plan does not necessarily mean that each instalment is a contingent liability prior to instalment date and a certain liability (debt) on instalment date. The parties are free to agree that the subscription price is a debt which is immediately due, albeit payable at certain dates in the future. The parties are free to agree that the subscription price is a debt, which is immediately due, albeit payable on events certain to occur on some date or dates in the future

15 167. On a superficial literal interpretation, the meaning of the subscription agreement is ambiguous: it does not contain explicit words indicating whether a call is required or not required. However the phrase "fully paid" suggests that payment has actually been received; in which case the necessity for a call simply cannot arise. But no payment has actually been received and the instalment plan indicates that as a matter  
20 of objective fact or book-keeping the shares are not "fully paid" but unpaid; in which case the necessity for a call may arise.

168. However, a literal analysis of "fully paid" is that the agreement is a call on the full amount, so that the instalments are merely payment dates of a debt. The literal meaning of "issued and allotted ... and fully paid" is consistent with "issued and  
25 allotted ... and called", and inconsistent with "issued and allotted ... and uncalled".

169. Similarly, the literal meaning of "fully paid" is consistent with "called-up share capital" and inconsistent with "uncalled share capital".

170. The subscription agreement may have been drawn up by lay-persons, and further, reflect a compromise to the extent that the agreement was the imperfect  
30 integration of the separately drafted agreements of the original shareholders and Mr Gray. However on a purposive interpretation, the meaning of the subscription agreement is clear. The background to the Shareholders Agreement was that in November 2000 the Appellant was in severe financial difficulties and on the brink of bankruptcy. The Appellant needed capital urgently. That is why the Appellant was  
35 willing to dispose of control to Mr Gray and the Shareholders Agreement describes the shares as "fully issued".

### Argument C

#### Simultaneous acquisition of "participator" status

40 171. The Respondents argue that a simultaneous acquisition of debtor and participator status is within s419. On signature of the subscription agreement, Mr

Gray simultaneously acquired in relation to the Appellant the status of participator and loan debtor.

***Relative timing of acquisition of participator status and of debtor status***

5 172. In HSP Financial Planning Ltd a partnership incorporated, transferring as a going concern its business (including goodwill) to the Appellant company, which by way of consideration issued and allotted its shares to the partners. Paragraph 118(1)(b) of Schedule 29 to FA 2002 (intangibles code) denied a writing down deduction for goodwill acquired from a related party. The Appellant argued that, under the sale of business agreement, the goodwill was acquired before the partners  
10 became entitled to shares in the Appellant. The Tribunal said

15 “In our judgment the words in paragraph 118(1)(b) “at the time of the acquisition is not a related party” did not apply to the situation in this case when the persons in question became related parties at the same moment in time as the time of the acquisition. The exclusion of related parties was not limited to persons who immediately before the acquisitions were related parties. ... the construction of paragraph 118(1)(b) as applying when a person became a participator at the same time as the acquisition is consistent with the purpose of the statute and with normal language.”

173. Section 417(1) reads in relevant part

20 “... a participator is ... (a) any person who ... is entitled to acquire share capital ... ”.

174. Schedule 29 to FA 2002 relies on s417 in the same way that s419 does. For the purposes of the intangibles code, a person is a “related party” if they are a “participator” as defined in s417 of ICTA. If a person is a participator at the time of  
25 acquisition of an asset, that person is a related or connected party at the time of acquisition of that asset.

175. The plain language of the enactment does not exclude simultaneity, because the simple present tense “is” is used, and not the qualified present tense “is already”. Had the legislature intended to limit the scope of the provision so as to allow particular  
30 investors to acquire control at the expense of the state and of creditors and minorities, then the legislature would have used appropriate words to achieve that effect.

176. In this appeal, when Mr Gray signed the subscription agreement he became entitled to acquire share capital in the Appellant. So on signature Mr Gray became a participator.

35 177. In *Alexander* the court did not accept the “relative timing” argument that a director who signs the memorandum of association does not become a director until after he has signed it, and cannot commit a breach of trust at the time when he signs it. Furthermore the “relative timing” argument is rendered ineffective by the “entitled to acquire” formula in s417(1)(a).

178. The Respondents accept the Appellants interpretation of s171 TCGA 1992, in relation to a “75% group”, but timing limitations in the context of s171 are not relevant to timing limitations in s419. The reason is obvious. The purpose of the entitlement definition in s417(1) is to expand the scope of the anti-avoidance provision in s419, while the definition of a 75% group in s171 seeks to limit the scope of the relief in s171 available to a company within a 75% group

179. As regards a 75% group, neither s170, the definition section for Part VI (in which s171 appears) nor s171 make provision for any special rules for the determination of when a person who does not hold a share in a company is nonetheless deemed to hold a share in a company. As regards a 75% group, neither s170 nor s171 make provision similar to the “entitlement concept” in the “participator” definition in s417(1) of ICTA. It follows that, for the purposes of s170(3), the determination of when a person holds a share in a company is dependent on fulfilment of the normal requirements of company law for the valid transfer of a share.

180. As regards the 51% subsidiary of the principal company in a group, s170(7) makes provision for a special rule for the determination of when a parent company is “effectively entitled” to certain economic benefits usually flowing from a shareholding. But that “entitlement concept” relates to avoidance by persons who are shareholders (e.g. share pool agreements, etc which avoid the ordinary proportional benefits of shareholding) rather than avoidance by persons who enjoy benefits of shareholding while avoiding the status of shareholder. Section 170(7) provides for a test of “diversion of economic benefits” but does not provide for an alternative test to the normal requirements in company law for the determination of when a person holds a share in a company. The effect of this rule is therefore not similar to the “entitlement” definition in section 417(1) of ICTA.

It follows that the s171 TCGA analogy cannot avail the Appellant.

***Simultaneous acquisition of debtor and participator status is sufficient***

181. An ordinary charging provision may be interpreted strictly. An anti-avoidance provision must be interpreted so as to advance the mischief against which it is directed.

182. The mischief at which s419 is directed is avoidance by dressing up emoluments of employment or distributions as loans, whether taking the active form of a transfer of funds (s419(1)) or the passive form of a failure to collect a debt (s419(2)). In the context of arrangements between investors, timing of loan contracts and share acquisition contracts are peculiarly features within the control of the contracting parties

183. A company and an individual are free to conclude a loan agreement first and the share acquisition agreement thereafter. For obvious commercial reasons (lack of security for the lending company) that sequence of events does not occur often outside of a closely held context. But it would defeat the intention of Parliament and

the purpose of the enactment if s419 could be frustrated by so simple and transparent an expedient as simultaneity.

### Conclusion

#### Argument A

5 184. Did Mr Gray incur a ‘debt’ to the Appellant under the extended meaning of ‘loan’ provided by s419 (2)(a) of ICTA 1988 by subscribing for the B ordinary shares in the Appellant on the terms that he did?

185. HMRC argue that a debt equal to the full amount of the instalments payable under the share purchase agreement arose when Mr Gray subscribed for shares in the  
10 Appellant.

186. The Appellant argues that Mr Gray did not incur a debt within the contextual meaning of s419. We agree that that liability and the meaning of ‘debt’ depends very much on its context, and that *Marren v Ingles* is clear authority for that proposition.

187. On an objective analysis and in the context of the mischief at which s419 is  
15 aimed, “debt” does not extend to circumstances where effectively Mr Gray was an investor and owed the company nothing. The liability of Mr Gray was a liability to honour an investment promise. This was a share subscription, not a share purchase. The subscription agreement refers to “fully issued”. Nothing in the terms relating to Mr Gray’s investment referred to “fully paid and called up”. It was not a liability to  
20 repay monies borrowed or owed. It was not a debt within the context of s419.

188. HMRC asserts that whilst they agree the Appellant’s description of the mischief as being “to counter tax avoidance by participators in close companies and specifically avoidance by the untaxed extraction of profits, assets or value”, extraction can include the forbearance of a liability. We do not agree with that assertion on the  
25 facts of this appeal.

189. The Respondents referred to the case of *Grant v Watton*. We agree with the Appellant that this appeal is entirely different to that case. In *Grant v Watton*, a company used its resources to provide services (as the facts were found) on a day-to-day or continuous basis. Subscription monies are not “company money” which a  
30 participator can use, take or hold until they are in the hands of the company. The most that can be said is that subscription monies which have been promised may be available to creditors in the liquidation; but they are not available to the company for participators to “take” or “hold”.

190. Given the financial position of the Appellant it is probably true to say that it  
35 would not, realistically, have been possible to extract assets or profits from the Appellant. If s419 applied how could the tax be paid, given the impecunious position of the Appellant? Would the Appellant sue Mr Gray for the debt? If successful, and if the Appellant paid the tax arising under s419, tax would have been paid on capital introduced into the company rather than on revenue or profits. Clearly that is not the  
40 intention behind s419 ICTA 1988.

191. If the Appellant moved into significant profit would it be acceptable from an accounting perspective for the company to write off that 'debt' against revenue? On a true analysis, using sound accounting principles, can it be argued that the Appellant has lost something which it previously possessed? The answer to both questions must be "no".

192. If HMRC are correct and "debt" or "loan" is caught by s419, tax will be payable on a truly arbitrary figure, the subscription price. The ordinary B shares created for the purposes of the subscription did not exist prior to the share purchase agreement being entered into. It cannot be argued that the shares were worth nothing at all, but the subscription price did not represent the value received by Mr Gray or "loan" to him by the Appellant. The subscription price represented the amount he was prepared to invest. It could have been much more, or much less. If tax is payable under s419, more or less tax will be payable depending on the amount invested by way of subscription. Tax will be payable on a figure which had no relevance in terms of extraction of funds from the company. The greater the subscription or investment the greater the tax, irrespective of whether the company had any assets or generated any profit. This would be illogical and cannot be correct.

193. As the Appellant argues, s419 ICTA 1988 and the term "debt" should be construed in such a way as to exclude their application to a liability to make a payment which is incurred on a subscription for shares for a price payable in instalments (such as a contribution of capital to a company: *Kretztechnik AG v Finanzamt Linz*).

194. As stated in *Kretztechnik*, when a company issues new shares it is not selling any existing intangible property or any right over a fraction of its existing assets. It is increasing its assets by acquiring capital, and acknowledging the new shareholders rights as residual owners of a previously non-existent fraction of the increased assets which they have contributed in the form of capital.

195. Again as the Appellant argued, the principle of purposive construction applies neutrally. It is open to both the Appellants and HMRC to seek such a construction: *HMRC v Taylor and Haimendorf* [2011] UKUT 417.

196. It is true to say that Mr Gray secured control of the Appellant. He perhaps could at some future date extract untaxed profits or value from the Appellant but if that situation arose, that is when s419 should bite. Securing control of a close company is not within the contextual or purposive meaning of incurring a 'debt' under s419 ICTA 1988.

197. The company's accounts cannot influence the construction of an earlier completed agreement. If taxpayers could retrospectively reconstruct the effects of transactions by subsequent accounting treatment, opportunities for avoidance would be significant. In any event the annual accounts of the relevant years were signed long after the Shareholders Agreement was entered into. The accountancy treatment of the subscription price cannot alter the legal effect of the share subscription agreement.

198. As stated by Arden LJ in *Astall v IRC* 80 TC 22 it is necessary to give a statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply, and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. We must analyse the facts and then ask whether they satisfy the requirements of the statute. As Lord Nicholls of Birkenhead said in *MacNiven v Westmoreland Investments Ltd* [2003] 1 AC 311, 320, para 8: "The paramount question always is one of interpretation of the particular statutory provision and its application to the facts of the case."

199. The purpose of s.419 ICTA 1988 is to impose a charge to tax where profits, assets or value are extracted from a company without a charge to tax (being usually a charge to tax on distributions or dividends). In our view there was no extraction of profits assets or value.

15 Argument B

200. Because the Appellant succeeds under argument A, it is not necessary to consider argument B. However, we do not agree that Mr Gray's prospective liability for future instalments of the subscription price arose only when an instalment fell due and remained unpaid. The Appellant says that 'debt' did not extend to a liability to pay the price for the shares by instalments on a future date. We do not agree that analysis. A liability was immediately created as evidenced by its treatment in the company's accounts. It was however agreed that the liability would be paid in instalments. It was a deferred payment agreement and therefore the company could not sue in debt until the instalment fell due and payable.

201. If we analyse the facts and principles from a company law perspective the conclusion remains the same. A member of a company is bound to pay the full amount unpaid on his shares, but unless the terms of issue so provide, he is not bound to pay up at once and is only bound in accordance with the Articles of Association of the company. When the liability to pay crystallises, the shareholder's liability to the company matures into a debt. There is however a difference between an action for specific performance of an investment promise, whether or not it relates to the acquisition of shares, and recovery of monies loaned and not repaid.

Argument C

202. Mr Gray was not an existing shareholder at the time that he subscribed for the shares in the Appellant. Section 419 uses the present tense "is a participator". It does not include a prospective participator. If liability is to arise under s419 it is necessary for Mr Gray to have been a participator in the company at the time it is "regarded as making a loan" to him.

203. Section 419(1) refers to a close company making "any loan... to an individual who is a participator..." The term "participator" is defined in s417 ICTA 1988. Adopting that definition, Mr Gray could not be described as a participator until he had

subscribed for shares. Until that point in time he would not be “a person having a share or interest in the capital or income of the company.” Within the meaning of s417. We agree with the Appellant that Mr Gray incurred a liability upon (but not prior to) the very act, which made him a participator in the company. Taking into account the context and the terms of Mr Gray’s subscription the loan did not constitute the sort of mischief at which s419 is aimed which is the prevention of existing shareholders/participants extracting funds from a close company in otherwise non-taxable forms. A purposive construction of the provisions of both s419 and s417 reinforces that analysis.

204. As the Appellant argues, the rationale behind Argument C is also consistent with the general position under UK tax law that, apart from transaction taxes, an investor dealing at arm’s length (and not acquiring anything at an undervalue) is not taxed on acquisition of an asset but only when he realises or profits from the assets in the ordinary course. Such a realisation or profit will be taxed under one or more heads of charge. In the close company context, s419 ICTA 1988 is designed to be engaged where tax on the realisation or profit is avoided through the making of a loan or the incurring of a debt. It is not designed to penalise, discourage or distort investment in close companies and should not be construed so as to apply to the making of an investment.

205. For the above reasons the appeal is allowed.

206. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

**MICHAEL S CONNELL  
TRIBUNAL JUDGE**

**RELEASE DATE: 30 January 2014**